



**Financial Risk Outlook  
Insurance Sector Digest  
2010**



**Delivering financial stability**

**Delivering market confidence**

**Delivering consumer protection**

**Delivering a reduction of financial crime**

© Financial Services Authority 2010  
25 The North Colonnade Canary Wharf London E14 5HS  
Telephone: +44 (0)20 7066 1000 Fax: +44 (0)20 7066 1099  
Website: [www.fsa.gov.uk](http://www.fsa.gov.uk)  
All rights reserved

# Contents

●●●●	Insurance sector leader introduction	3
●●●●	Overview of the insurance sector and operating environment for insurance firms	5
●●●●	Life insurers	5
	Macroeconomic background and outlook	5
	Operating environment	6
	Regulatory and legislative environment	7
	Analysis of key risks for life insurers	8
	Key messages	10
●●●●	General insurers	11
	Macroeconomic background and outlook	11
	Operating environment	11
	Regulatory and legislative environment	11
	Analysis of key risks for general insurers	12
	Key messages	13
●●●●	Wholesale insurance intermediaries	14
	Macroeconomic background and outlook	14
	Operating environment	14
	Regulatory and legislative environment	14
	Analysis of key risks for wholesale insurance intermediaries	14
	Key messages	15
●●●●	Solvency II	16
	Key messages	17
●●●●	International developments	18

The Financial Services Authority invites comments on this Sector Digest.  
Comments may be sent to [insurancesectormailbox@fsa.gov.uk](mailto:insurancesectormailbox@fsa.gov.uk)



# Insurance sector leader introduction



**Ken Hogg**

We are publishing this Insurance Sector Digest alongside the Financial Risk Outlook (FRO) to give extra focus to the risks and issues pertinent to the insurance sector in 2010. In the FRO we describe the main risks and issues presented by the operating environment and in particular the prudential challenges for insurers. We develop some of those challenges further in this Digest, as well as raising other key issues for insurance firms.

This Digest provides a further overview of the operating environment and focuses our analysis on key risks and issues for life insurers, general insurers and wholesale insurance intermediaries. It also discusses Solvency II and wider international regulatory developments.

It is important that firms' governing bodies reflect carefully on the issues raised in the FRO and this Sector Digest, and satisfy themselves that they are addressing these appropriately. Although market conditions are more benign than in early 2009, there are still many short-term and longer-term challenges facing the insurance sector.

This Digest does not return to the ongoing risks posed by terrorism or pandemics, which have been covered in previous publications. However, we would expect insurance firms to continue to consider the implications for their businesses of potential catastrophe scenarios as part of their risk and capital management activities.

The outlook for the macroeconomic environment and the uncertainty around the shape and pace of recovery will make it difficult for UK insurers to return to the levels of income and profitability experienced before the financial and economic crisis. Environmental changes may prompt firms to alter their business activities, for example by moving into new product areas or selling into new markets, to address potential losses of profit streams. This could impact the risk profile of firms which, if not addressed appropriately, could threaten solvency positions and might raise concerns over the fair treatment of consumers.

The financial crisis has resulted in some long-term structural changes to industry and commerce in the wider economy, and this may have fundamentally altered the characteristics of some risks underwritten by the insurance industry. It is therefore important for firms to be cautious when using past data for pricing and reserving purposes.

This Digest also highlights a number of important areas of focus for insurers and intermediaries. Firstly, robust capital management is essential to withstand further shocks. Secondly, firms need to undertake regular stress testing to maintain an awareness of their key vulnerabilities to changes in economic and trading conditions. Finally, firms should ensure that products offer real benefits to customers, that the risks and limitations of products are made clear, and that firms themselves understand the risk management implications for their business. In summary, we want a market that is both good for consumers and viable for the industry.

Firms need to be alert both to the impact that Solvency II will have on their capital position, and to the demands it will place on their people, pre- and post-implementation. Effective implementation of this new regime will bring considerable long-term benefits to the sector, and will improve the quality of firms' risk management.

Finally, Solvency II is not the only important development that will materially impact the sector in the longer term. There are other changes, including the Retail Distribution Review, the review of the Insurance Mediation Directive and pension reforms, all of which will alter the landscape for insurers and other financial firms. Many of these developments are intended to change the way the market operates from a consumer perspective, removing some of the barriers that may have inhibited some people from addressing their savings and protection needs. Indeed, these changes offer significant opportunities for those insurers who put the consumer at the heart of their business. Nonetheless, the combination of forthcoming regulatory and legislative developments, coupled with material changes to the macroeconomic outlook and continuing future uncertainty, will be hugely challenging and may raise issues over the sustainability of the life insurance sector in particular. Firms should therefore maintain a flexible and vigilant approach to managing their businesses.

I hope you find this Digest helpful and I would welcome your feedback.

## Overview of the insurance sector and operating environment for insurance firms

This section builds on the analysis of the outlook for the economy and firms presented in the Financial Risk Outlook (FRO) 2010. We highlight below the issues and risks that are relevant to the insurance sector and provide a high-level analysis of key risks for life insurers, general insurers and wholesale insurance intermediaries.

### Life insurers

#### Macroeconomic background and outlook

In 2008 and early 2009, life insurers' capital levels came under pressure as asset values fell and a combination of lower interest rates and higher costs of embedded guarantees led to rises in liability values. New business profitability also continued on a downward trend, reflecting lower volumes and tighter margins. However, over the course of 2009, equity markets and property prices partially recovered and credit spreads narrowed. As a result, capital levels for many, but not all, life insurers are now comfortably above minimum requirements. One ongoing challenge is the continuing market illiquidity for some assets, particularly certain corporate bonds. Such issues may cause further valuation difficulties, extending the accounting challenges some insurers have faced over the course of the crisis.

*Environmental uncertainties will continue to challenge firms.*

The UK emerged from recession in the fourth quarter of 2009; recovery is likely to be weak and the economy remains vulnerable to further shocks which could affect performance across all asset classes. In the longer term, ongoing uncertainty in the macroeconomic environment, as well as future regulatory changes, will continue to challenge firms' risk management. This may also limit the extent to which life insurers can return to the levels of profitability experienced before the crisis.

Within the life insurance sector, with-profits and annuity providers have been most affected by the changes in economic conditions. Low interest rates and volatile equity markets are challenging for many with-profits providers, who have to balance maintaining adequate solvency levels with giving their consumers a fair deal. Annuity providers typically use corporate bonds to match their liabilities and so are particularly exposed to renewed widening of credit spreads on those bonds which would cause asset values to fall by more than liability values. In addition, these firms could face capital erosion under current Solvency II proposals, which would impose a significant strengthening of the liability calculation for annuities. Firms may not be able to continue to take credit for the illiquidity premium within corporate bond yields when valuing their annuity liabilities. This issue is explored in more detail in the *Analysis of key risks for life insurers* section below.

*M&A activity increases potential for consumer detriment.*

As economic and financial market conditions ease, an increase in mergers and acquisitions (M&A) and related activity may occur in the life sector. This could give rise to a number of issues, including increased likelihood of consumer detriment. We have been closely monitoring developments in this area, both within the insurance sector and across other sectors. A number of key observations relevant to life insurers have emerged:

- M&A transactions financed by debt will increase leverage and diminish the quality of capital. This could adversely affect capital management and put pressure on firms to generate cash flows to service the debt, particularly in stressed conditions, potentially to the detriment of policyholders.
- Takeovers may be hastily finalised, leading to uncertainty in strategy and poor execution of subsequent integration. There may be resulting increases in complexity of the business and insufficient due diligence carried out, posing a material risk of unexpected consequences. The complexity of blending two or more legacy businesses and associated systems, especially if there is poor documentation of products and processes, could potentially lead to errors in administering consumers' policies.
- Financial pressures arising from M&A activity can lead to firms maximising short-term business gains at the expense of core infrastructure investments, such as risk management, regulatory reporting or accounting systems. Moreover, the quality and responsiveness of customer services could diminish greatly.

## Operating environment

*Pressure on the long-term funds of life insurers will continue.*

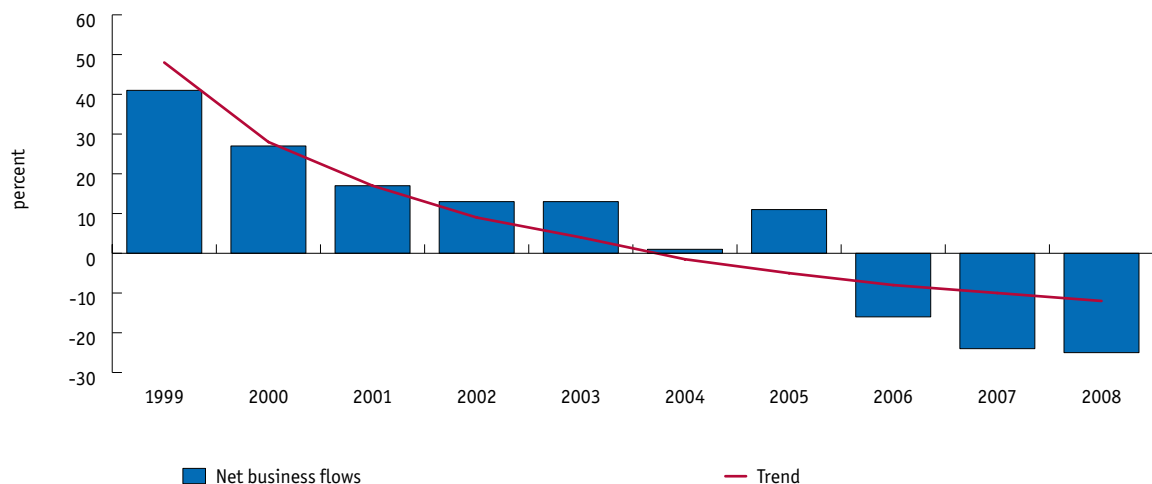
Consumer confidence remains low and consumers' disposable income is under pressure as a result of high levels of household indebtedness, low earnings inflation and adverse investment market conditions. This is likely to reduce demand for life products, both savings and protection. The current uncertainty in the housing market, arising from the lack of mortgage credit facilities, and associated protection needs for first-time buyers, will further weaken demand. UK new life business levels for the whole of 2009 were down for most major quoted life insurance groups compared with 2008, but appeared to recover in the second half of 2009 to a limited degree.

In addition to the balance sheet impact of economic conditions, margins are also threatened by poorer persistency, as historically more people lapse or surrender their policies during recessionary periods. For example, for unit-linked business, management charges are typically based on fund values, and profitability will be affected not only by any further reductions in market values but also by reduced future levels of premium inflows.

*Business levels are declining, adding to pressures on firms.*

Cash outflows from existing books continue to exceed new inflows across the life insurance sector on an aggregated basis (see *Chart 1*). The chart illustrates changes in flows of money passing between the industry and consumers, and indicates how the net flow is now very much away from the industry and back into the hands of consumers. The decline in net business flow (defined as premium income less claims incurred as a percentage of claims incurred) partly reflects diminishing levels of new long-term savings from consumers, in particular lower contributions to pension arrangements, and is partly due to the effect of increasing amounts of money being withdrawn through maturities, surrenders and annuity payments not being reinvested in insurance products. Due to the size of the back book, it is likely that a large scale upturn in genuine new money inflows (as opposed to recycled transfers of in-force books of business) will be required to reverse this trend. As fund sizes diminish, pressure is placed on unit costs, which then erode margins unless firms are able to operate more efficiently and in line with their reducing size.

Chart 1: UK life insurance sector net business flows



Source: FSA returns – all life firms

Note: Net business flows are the excess of premium inflows over claims incurred as a percentage of claims incurred.

The introduction of the National Employment Savings Trust (NEST – formerly known as Personal Accounts) as part of the pension reforms to be implemented from 2012 will pose further challenges to the sector. New business that would otherwise have gone to the industry may go into the national scheme instead (see the *Regulatory and legislative environment* section below for further detail). The impact will vary across the market, and it is important that firms consider carefully how this development might affect their business. To the extent that a firm may face a significant erosion of new business levels, it should be mindful of the risks when considering whether to offset its loss of income by venturing into new products or



markets. There are a number of tactics that firms might consider in these circumstances, some of which we outline below.

*New types of product pose additional risks to firms and consumers.*

Firms may consider moving into new, higher margin products such as variable annuities. These offer a range of guarantees to consumers, which can be costly to provide and often require long-term active management of hedging programmes to deliver the guarantees and prevent erosion of the provider's capital. The increase in prudential and operational risks for insurers needs to be well managed. There is also a potential risk of poor returns for consumers if, for instance, product pricing (which includes the cost of guarantees) leads to charges exceeding potential investment returns. There are significant risks of consumer detriment if sold to consumers who may not fully understand either the investment risk they might be taking on the likely cost of the product compared with the potential reward.

Income drawdown may be attractive as an alternative to an annuity, but is normally only appropriate for customers with larger pension pots, whose risk appetite may be greater than is the case for many consumers with smaller sums available. In addition, certain charging structures could have a greater impact on smaller case sizes. Data shows that sales to customers with under £100,000 of retirement assets are increasing. These consumers, in particular, need to be aware of the risks they are exposed to and the potential costs and benefits of their products. Moreover, all income drawdown holders should regularly monitor their portfolios and firms should prompt them to consider whether advice needs to be sought.

*Higher commission-bearing products may incentivise unsuitable sales.*

There is emerging evidence of a general push for sales of products paying higher commission ahead of the implementation of the Retail Distribution Review (RDR) in 2012. For example, although investment bonds have a valid place in many consumers' investment portfolios (not least as part of Inheritance Tax planning), changes in Capital Gains Tax introduced in 2008 might have been expected to reduce the relative attractiveness of the product compared with substitutes, for example unit trusts. However, sales figures from 2009 show an increase in sales of investment bonds, with significant rises for some insurers. Anecdotal evidence suggests that some commission rates are rising, providing incentives to some advisers to sell unsuitable products to their clients.

### Regulatory and legislative environment

*Pension reforms...*

The implementation of pension reforms is set to begin in October 2012. Once fully operational, all employers will have an obligation to provide and contribute to a pension for their employees on an automatic enrolment basis (dependent on age and earnings). As part of the reforms, NEST will act as a central scheme for employers to use to fulfil their obligation.

These reforms are likely to have a widespread impact on the pensions and investment markets. In the period before 2012, uncertainty among consumers could result in delayed decisions about retirement saving. There is also a risk that advisers and providers may withdraw from certain segments of the market if they believe their business will lapse in 2012. Firms need to ensure that this potential additional lapse risk is factored into their longer-term financial planning, as well as considering the strategic implications for their business following the introduction of NEST.

*...and taxation changes form part of a range of forthcoming market developments.*

HM Treasury and HM Revenue and Customs are currently reviewing and consulting on the basis for tax computations for insurers following the implementation of Solvency II. Although this work is still at a relatively early stage, it could lead to significant taxation changes (and rises or reductions for some firms), which may place additional pressure on their balance sheets. Insurers should ensure that they maintain a watching brief and should consider the implications for their financial management as change proposals are announced and consulted on.

*Stress testing remains an important exercise for firms.*

The financial crisis highlighted the importance of regular and ongoing stress testing. In December 2009, we published a Policy Statement (PS09/20) to strengthen our stress testing regime for all firms. The policy statement focused on three key issues: improving stress testing capability; enhancing capital planning stress testing; and undertaking reverse stress testing, where firms are required to identify and assess scenarios most likely to cause their current business models to become unviable. As part of this, we may periodically ask certain insurance firms to participate in a simultaneous system-wide stress test using a common scenario to enable us to gauge the effects of stresses for financial stability purposes.

## Analysis of key risks for life insurers

### Capital and solvency

Market conditions continue to put pressure on insurers' earnings and excess capital. Those more exposed to falls in asset values run a greater risk of excess capital reductions and, potentially, capital requirement breaches.

*Capital levels have improved but pressures remain.*

Although the UK life sector has, on the whole, withstood the stressed market conditions, it may find it difficult to take further management actions to preserve capital in the event of further economic decline. Some proprietary life insurers may also find it difficult to raise additional capital from investors. As a result of this and other factors, the life sector is continuing to explore innovative ways of leveraging capital. We expect insurers to review such ideas critically, as we will, to ensure that there is genuine risk transfer and to avoid solutions that may artificially manufacture capital.

There are other potential capital and solvency concerns. Inadequate monitoring of solvency positions may lead to insurers being unable to take action sufficiently early to reduce the risk of financial failure. It may also increase the risk that actions taken to conserve capital will result in poor consumer outcomes.

Secondly, insurers could fail to value illiquid assets in a prudent manner. This could lead to an overstatement of asset values and could lead to solvency difficulties.

Where insurers hold substantial amounts of bonds which are not redeemed at the expected redemption date, matching and liquidity problems could result. Furthermore, annuity writers could make inadequate provisions for credit default risk in their corporate bond portfolios in both their Pillar 1 and Individual Capital Adequacy Standards (ICAS) calculations. This could also lead to solvency difficulties.

Finally, if guarantees and options are inappropriately valued and insufficient stress and scenario testing is carried out, this may result in inadequate assessments of capital requirements, particularly in a low interest rate environment.

### Sustainability of business models

The aggregate impact of macroeconomic trends and material market and regulatory developments will have a major impact on the UK life insurance sector. Forthcoming developments include: the implementation of Solvency II and other new EU-wide initiatives; the implementation of the RDR; pension reforms; and changes to the UK tax system. As with any changes of this magnitude, these developments present both opportunities and risks for insurers, and may challenge the sustainability of certain business models. Firms that do not monitor developments or periodically re-evaluate their strategies and market positioning are more likely to struggle in the emerging environment, face higher risks of financial failure or disorderly run-off, and may cause consumer detriment.

*Strategy reviews need careful consideration to avoid introducing new risks.*

In an attempt to remain viable as solo entities, some insurers may develop new product lines. There is a risk that consumers may be inappropriately targeted if the insurer's primary objective is to boost business volumes at the expense of fair treatment of customers. Some firms may consider merging when future viability as a solo entity is questionable. There is a risk that incompatible partnerships could emerge. Insurers may take over businesses in which they have limited experience, giving rise to both prudential and conduct risks, as well as governance concerns. Such risks may include failure to value liabilities properly for unfamiliar businesses, poor integration leading to potential operational inefficiencies in the combined entity, and poor consumer outcomes due to failure to follow through on previous commitments made to customers.

### With-profits

There are risks of material customer detriment in managing with-profits products. These stem from a number of inherent product features, including the difficulties of delivering clarity and transparency on potentially complex operational issues, managing the different expectations of groups of policyholders, and dealing with the various conflicts of interest between groups of policyholders and, for proprietary

businesses, between policyholders and shareholders. The with-profits market is substantial with approximately 28 million with-profits policies in force with £338 billion of assets as at the end of 2008.

*Poor management of with-profits poses risks to policyholders.*

Particular risks that can lead to poor outcomes and inappropriate management of expectations for consumers include:

- Governance that does not properly protect with-profits policyholders' interests or take their interests into account in actions taken by the firm;
- Investments that may not be appropriate to the with-profits fund, and which prevent policyholders from receiving fair value in any pay-outs or bonus distributions. This may also be caused by low levels of excess capital resources within a wider group structure prompting utilisation of with-profit estate capital for support of strategic investments, such as intra-group or contingent loans, in a way that is detrimental to policyholders;
- Policyholders bearing costs that are not related to the running of the fund;
- New business being written on terms that are likely to be detrimental to existing with-profits policyholders;
- Customers not receiving sufficiently comprehensive, timely and clear information to enable them to take a reasonable view of the risks and benefits of their with-profits policy;
- Firms whose new business volumes are materially diminishing, and those running closed funds, which are not fully addressing financial or operational risks and not acting early enough to formulate and implement coherent plans to distribute assets held within the fund in a way that is fair to all policyholders;
- Firms not using tools such as Market Value Reductions (MVRs) fairly and proportionately to ensure all classes of policyholders are treated fairly; and
- Outsourcing administration and asset management functions (for the purpose of rationalising or controlling cost bases) which magnify conflict of interest issues, particularly where the outsourcing provider is connected to the firm.

Some of the above risks become more acute in recessionary or volatile market conditions. For example, recent conditions could have the effect of exposing any previous pricing weaknesses where terms of business were written with heavy guarantees that are not self-supporting. This could lead to a firm seeking to offset the cost of such guarantees by reducing bonuses, increasing charges to policies and increasing MVRs in a way that is unfair to policyholders. It could also create an incentive for a firm to use inherited estates and existing policyholders' funds to finance the guarantees for new business. Such actions could be unfair to other policyholders and lead to adverse perceptions about the firm or the sector.

### Annuity providers

Market turbulence in late 2008 to early 2009 led to a pronounced widening in corporate bond credit spreads. This was a particular issue for annuity providers because annuity liabilities are backed predominantly by corporate bonds. Although large increases in bond spreads did not necessarily imply similarly large increases in the probability of default, some insurers took less account of the credit default risk (in other words took more benefit from the illiquidity premium) in calculating their liabilities than we considered prudent, and we have taken steps to address this.

*Careful consideration is needed for ongoing assessments of credit risk.*

Throughout the second half of 2009 credit spreads narrowed. We continue to expect firms' senior management to challenge their own assumptions and reach careful and well-considered judgements in this area. These judgements should be informed by on-going stress testing so that management remains alert to the possibility of alternative scenarios, such as the economic recovery stalling and credit spreads widening again.

As we discuss in *Section B* of the FRO, it is also important that annuity firms and reinsurers keep up to date with longevity research and that they continue to analyse their own mortality data to assess trends. Although future trends are subject to considerable uncertainty, we expect that many firms may need to strengthen their longevity assumptions further in the future.

Furthermore, firms that are growing their annuity business at a fast rate are particularly vulnerable to solvency problems if they do not make sufficiently prudent assumptions in their pricing and reserving.

### Key messages

- Without significant changes in approach, it is unlikely that the trading environment will allow firms to return to the levels of income and profitability experienced before the crisis. It is important that firms ensure that they have sufficient understanding of the risks inherent in any new activities that they might undertake.
- Insurance products should be designed, targeted and marketed appropriately to reduce the risk that consumers buy inappropriate products.
- Firms should pay careful attention to capital management and planning, with a particular focus on the risk of a further downturn in the economy. They should exercise prudence in the valuation of assets and liabilities, and ensure that assets and liabilities are appropriately matched by duration.
- The combination of substantial regulatory and legislative developments, coupled with material changes and continuing uncertainty in the macroeconomic outlook, will challenge the sustainability of the sector. Given this backdrop, firms must undertake a regular and challenging reassessment of their strategy, and the adequacy of their resources to deliver their strategy, in order to validate whether it remains fit for purpose.
- Firms undertaking merger and acquisition activity need to ensure that they manage any new debt financing obligations appropriately, and that they treat customers fairly both during the transition period and thereafter. Adequate records need to be maintained for legacy business to ensure that liabilities can be properly calculated and that customers are treated fairly and in accordance with promises made when they bought the product.

## General insurers

### Macroeconomic background and outlook

*Reserving adequacy may be threatened by underlying environmental factors.*

Reserving adequacy has re-emerged as an issue for general insurers. Firms have been progressively releasing surplus reserves and there is concern that recent levels of releases are likely to be unsustainable. Firms are also vulnerable to inflationary conditions, which could further expose material reserving inadequacies. Some firms risk compounding these problems by underpricing new business to remain competitive. Lower investment returns and a more limited scope to release prior year reserves mean that general insurers need to continue to underwrite on profitable terms, as they cannot rely on investment income or reserve releases to subsidise underwriting losses. Latent claims relating to the financial crisis remain a concern, although there is considerable uncertainty over when and how these might materialise. In the meantime, firms who may have exposure to such claims need to consider carefully their approach to reserving and capital planning.

The recession may have fundamentally changed the nature of certain insurance risks underwritten within both personal and commercial lines; the latter, for instance, reflecting changes to the structure and operation of the manufacturing industry and commerce across the wider economy. This has implications for underwriting, pricing and reserving.

The slowdown in economic activity in 2008/09 has affected business volumes across several lines of general insurance business. Firms may seek to bolster margins by taking actions that could cause consumer detriment; for example, applying unfair contract terms (as occurred in 2009 with Mortgage PPI), unfairly rejecting claims, reducing claims payments or introducing products that do not appear to offer any real benefit to consumers.

Further sizeable movements in exchange rates also pose threats to profitability and capital. In some firms, capital may be held in a different currency to certain insurance liabilities. Moreover, even where all business is carried out in one jurisdiction, the cost of claims may be related to the cost of materials manufactured elsewhere, extending foreign exchange risk even to those without international operations.

### Operating environment

The UK non-life market remains competitive, especially in the retail sector. The continued growth of aggregator websites is adding competitive pressures. At the same time, recent industry statistics indicate average motor insurance premiums are rising and the cost of household insurance is also increasing. Although these increases are probably needed to deliver underwriting profitability, competitive forces could reverse this.

*Reinsurance rates may have softened in some classes.*

In reinsurance markets, a relatively benign period for catastrophe losses and some improvements in financial markets have improved reinsurers' balance sheets. Initial indications and market comment reflect 2010 reinsurance renewal rates softening, with 5% to 10% rate decreases in many of the main product markets, which may bring down rates offered by primary insurers.

It has been widely reported that the incidence of fraud, both in terms of volume and augmented claims size, becomes more prevalent in recessionary conditions. This is a material risk that firms should monitor closely.

### Regulatory and legislative environment

*A wide range of developments may radically alter the operating environment.*

There is increasing uncertainty surrounding the future basis for taxation of firms. HM Treasury and HM Revenue and Customs are currently reviewing and consulting on the basis for tax computations for insurers following the implementation of Solvency II. Although this work is still at a relatively early stage, it could lead to significant taxation changes (and rises or reductions for some firms), which may place additional pressure on their balance sheets.

We have also seen examples of tighter regulation by the tax authorities. For instance, new anti-avoidance measures were announced in the Pre Budget Report in November 2009 aimed at tackling the bundling of services with insurance and removing the loophole over the tax treatment of fees for services in insurance contracts.

Various insurance-related directives are being reviewed by the European Commission and this could lead to changes to UK rules. The Insurance Mediation Directive (IMD) is in the early stages of a review and the European Commission is currently developing its proposals on the future shape of the directive. The European Commission intends to present revised directive text (IMD2) to the European Council and European Parliament in early 2011. We, along with other regulators within CEIOPS, are participating in the IMD review process, and will be working to ensure that any revisions allow us to maintain regulation that is both proportionate and effective.

There are continuing risks of adverse judicial and political developments arising from latent claims – in particular, asbestos related cases. The government has announced recently that the Law Lords' 2007 ruling on pleural plaques should not be overturned at this time and that compensation will not be payable for this condition in England and Wales. However if new medical or other significant evidence were to emerge, the government will reassess the situation.

*The Review of Civil Litigation Costs may have implications for firms.*

Lord Justice Jackson's report on the fundamental review of the rules and principles governing the costs of civil litigation, focused on promoting access to justice at proportionate cost, was published in December 2009. The report proposals include a wide-ranging package of reforms designed to bring costs under control and make them fairer. If the proposals from this review are implemented, there will be changes to the operation of the legal expenses insurance marketplace which will impact those firms active in this particular market.

### Analysis of key risks for general insurers

In a recession, insurance claims tend to increase in terms of the number, size, and diversity of claims made. There are a number of causes including increased levels of 'social' crime, such as theft, which affects property and motor and increased financial losses from credit card and mortgage defaults. In addition, there can be increased levels of claims fraud and a higher propensity to claim. There can also be changes in types of claim, for instance more liability claims (perhaps encouraged by the actions of Claims Management Companies). These developments can materially distort insurers' historic claim cost trends and should be taken into account when assessing reserves.

*Claims inflation is a particular threat.*

While the claims environment of the past decade has been broadly benign (with the exception of events such as Hurricane Katrina and the 9/11 terror attacks), there remains a risk of a sharp increase in claims inflation. A major risk for insurers is that claims and underwriting staff may have no experience of an environment of claims inflation and therefore may not fully appreciate the risks entailed. Early warning signals may not be noticed or may be ignored until too late. Monitoring systems need to be put in place or maintained and firms should also consider this risk as part of their ICAS processes.

The inflationary influences on claim sizes and volumes may encourage firms to tighten claims management processes. Firms should ensure that this does not have any consequential detrimental effects on customers who are making legitimate claims.

### Capital and solvency

The reduction in economic activity is causing reduced business levels and cost pressures on firms, as well as increasing competitive pressures. However, with reduced investment returns, often relied upon by non-life insurers especially for longer tailed business, insurers should be focussed on profitable underwriting. Moreover, as highlighted during the financial crisis, regular stress and scenario testing is essential.

*Some firms may not have updated their reserves to reflect the latest asbestos-related claims projections.*

The Actuarial Profession's UK Asbestos Working Party reported in January 2010 that it had updated its previous projection models for asbestos-related claims. The current estimated cost of these future claims to the UK insurance industry from 2009 onwards has doubled to around £10 billion since the working party's 2004 projections, although the report explains that there is considerable uncertainty in the estimate. Over 90% of this cost relates to mesothelioma claims. While these increased cost estimates will have already been factored into reserves by some insurers, other firms may not yet have fully reflected these higher estimates.

Other solvency-related risks facing general insurers include:

- Adverse development of financial lines claims (Directors & Officers and Errors & Omissions classes) caused by the financial crisis where the claims costs will take time to emerge fully;
- An increased propensity for claims ‘farming’, for example by Claims Management Companies, which can lead to higher operational expenses when settling claims;
- Foreign exchange movements which can have adverse repercussions for capital levels, particularly for those insurance groups with major overseas exposures or global reinsurance arrangements; and
- Failure to apply appropriate oversight to counterparty exposures, particularly in respect of reinsurance.

### Conduct issues

*Revenue and profitability concerns may prompt firms to adopt poor practices.*

Increased pressure to move to profitable underwriting may prompt insurers to reduce policy coverages, resulting in the possibility that some consumers may not realise that they are not covered for certain events. This can be exacerbated by use of aggregator web sites where a price-ranked view for consumers may lead to reduced transparency of what the policy actually covers.

Firms may also consider developing and launching new products which are of questionable value for consumers, or contain unfair contract terms, in order to replace reductions in other income streams.

### Key messages

- Insurance products should be designed, targeted and marketed appropriately to reduce the risk that consumers buy inappropriate products.
- Consumers should ensure they understand the full terms and conditions of general insurance products such as motor, home and travel insurance, including features and exclusions such as excesses and coverage for special items. This is particularly important for products purchased through aggregator sites. Firms involved in the sales process of such products should ensure the information needs of consumers are met, particularly given the focus on price.
- The long-term structural changes to the wider economy arising from the financial crisis may fundamentally alter the characteristics of some risks insured by the industry. It is essential for firms to consider this, so that they establish appropriate reserving, pricing and underwriting strategies.
- A recession can trigger significant increases in the number, type and size of claims made. This can materially distort insurers’ claim cost trends and needs to be taken into account in reserving. Monitoring systems need to be put in place and firms should also consider this issue as part of their risk and capital management processes.

*Pressures on firms' revenue streams continues.*

## Wholesale insurance intermediaries

### Macroeconomic background and outlook

Wholesale insurance intermediaries' main client base comprises of a broad cross-section of UK and global customers, many of which have been affected by the recessionary conditions. The resultant lower demand for insurance is placing pressure on intermediary revenues.

The difficult economic environment continues to have a negative impact on revenue streams for wholesale insurance intermediaries. The impact is two-fold. Firstly, there is generally lower demand for insurance due to diminished economic activity, such as in the construction and shipping sectors. Secondly, the global downturn has resulted in declining prices for commodities such as oil and copper, which in turn has reduced the sums requiring insurance and thereby limited broker commissions.

The low interest rate environment may tempt intermediaries, especially if they are under revenue pressure, to take more risks with their assets and client money to counter the loss of investment income from their usual cash investments.

A number of intermediaries may also experience increased risk from the impact of the recession on non-regulated parents, particularly if there is high debt leverage at holding company or sister company level.

The viability of business models of some wholesale insurance intermediaries depends on further acquisitions which are often financed through debt. As a result of the economic downturn, firms may not be able to meet principal or interest payments. There is also a risk that firms may find it difficult to refinance maturing debt, or only at markedly higher interest rates. Firms may also be forced to write down a considerable amount of goodwill from future acquisitions as a result of over-optimistic assumptions about the recoverability of the purchase price from future profit streams.

### Operating environment

The competitive environment is being driven by economic pressures, forcing intermediaries to compete for reduced volumes of business, increasing disintermediation efforts by some insurers and creating pressure on commission and fee rates from both customers and insurers.

### Regulatory and legislative environment

Our approach on transparency, disclosure and conflicts of interest in the commercial insurance market sets out five target outcomes for commercial customers. These outcomes have been developed in the knowledge that, although intermediaries are largely managing conflicts of interest appropriately, more should be done to improve transparency. For example, the capacity in which an intermediary is acting and how he is remunerated are not always apparent, and clearer descriptions of an intermediary's services would be helpful. Intermediary associations will be promoting their guidance amongst firms and offering practical advice aimed at helping firms achieve positive outcomes for consumers.

### Analysis of key risks for wholesale insurance intermediaries

#### Threshold Condition 4

*Regular reassessment of adequacy of resources is essential.*

There is a risk that many insurance intermediaries cannot demonstrate they have adequate financial resources. Our supervisory work frequently shows insufficient attention to threats to the financial viability of firms. Consequently some firms are not taking steps to guard against such threats or to develop management plans in case they happen. We expect firms to undertake a regular Threshold Condition 4 assessment, so they can demonstrate that they have adequate financial (and non-financial) resources and, if necessary, make good any deficit.

#### Client Money

There is a risk that wholesale insurance intermediaries have inappropriate controls and processes in place around the holding of client and insurer assets and are not always providing an adequate level of protection. We view the protection of client money and assets as fundamentally important, and firms must comply with the requirements set out in the Client Asset Sourcebook (CASS).



### Financial crime

Current economic conditions heighten the risks arising from financial crime. These could include claimant fraud or internal fraud (in relation to client money or claims), as well as falsified insurance documentation and corruption amongst intermediary employees. Firms should ensure their control systems remain sufficiently robust to prevent financial crime wherever possible, and to quickly address it should it occur.

### Acquisitions, consolidation and expertise

The business models of global brokers, as well as consolidators<sup>1</sup>, are typically based on achieving growth through acquisitions. Such acquisitions by the holding company can threaten the regulated entity if the integration is not successful or if the group fails to put adequate risk controls in place. The increasing size of consolidators requires more sophisticated governance systems and controls. The complexity of these groups raises the risk of failure and could impact other consolidators, especially if the consolidator model is perceived as a failure by investors and market participants.

We also have concerns that in order to compensate for declining commission and investment revenues some firms may expand into new advisory areas where they have insufficient expertise.

*Inadequate controls will undermine successful acquisitions and can threaten the business.*

#### Key messages

- Firms should be making a realistic assessment of the amount of capital required to run their business effectively in order to ensure they meet threshold financial conditions appropriately on an enduring basis.
- As with some firms in other sectors of the financial services industry, we are concerned that some wholesale insurance intermediaries have inappropriate controls and processes in place around client money and assets. We view the protection of client money and assets as a fundamentally important part of regulation, and firms should comply with the requirements set out in the Client Asset Sourcebook (CASS).

<sup>1</sup> Consolidators are intermediary firms whose growth strategy is inorganic, often using debt finance for acquisitions.

## Solvency II

*Solvency II implementation is the biggest current challenge for insurers.*

Solvency II will fundamentally change the capital adequacy regime for the European insurance industry. It aims to establish an enhanced, more risk sensitive set of EU-wide capital requirements, require robust risk management standards, and provide consistent measurements of assets and liabilities. There will be new regulatory returns and public disclosure requirements for regulators and firms. For the UK, Solvency II builds on the strong foundations established by our current ICAS framework and seeks to address the same economic capital and risk management standards issues. The directive will replace the current Solvency I requirements and ICAS regime. All firms in scope<sup>2</sup> will need to review their operations and, given the far reaching nature of the directive, all of these firms will need to make changes.

*Firms should be planning their implementation and allocating resources accordingly.*

Solvency II will come into force on 31 October 2012 and firms should be well advanced in planning their implementation. We expect there will need to be a substantial increase in activity to prepare for Solvency II this year if firms are to be ready in time. Given the extent of the changes necessary prior to implementation, there is a risk that if firms do not engage early enough or allocate sufficient resources, they will not be ready by the implementation date. Although there are material technical issues that are not yet finalised, firms should not wait for these to be resolved. There are bigger risks associated with inadequate engagement than with managing the uncertainty.

We expect the European Commission to propose the Level 2 (L2) Implementing Measures in the final quarter of 2010. The European Parliament will finalise L2 in second quarter 2011, CEIOPS will publish Level 3 (L3) in fourth quarter 2011 and the Commission will adopt L3 in first quarter 2012. The ongoing nature of the negotiations means that firms will need to build their implementation plans without certainty over the final shape of technical Solvency II requirements. The uncertainty over the outcome and the associated timelines for decision making will require firms to develop flexible implementation plans. If firms do not familiarise themselves and monitor developments in the process and content of Solvency II, their implementation plans may rapidly become outdated.

*The ICAS regime gives UK firms a head start but there are many new requirements.*

The ICAS regime in the UK provides a good starting point for firms to make the transition to Solvency II, but the new directive goes much further. In a number of areas, the underlying calculations in our current regime are different from those expected under Solvency II. Participation in Quantitative Impact Study 5 (QIS 5) is essential to give CEIOPS an understanding of the impact of the L2 Implementing Measures on different sectors and countries, and will help identify any issues in their proposals and whether they are realistic and practical. The findings will input into the final L2 Implementing Measures and will help determine where L3 guidance could be required. In addition it will provide firms with a chance to comment on the measures and to assess the impact the proposed L2 measures will have on their own business.

Furthermore, the requirements for firms in terms of delivering and demonstrating the standards for risk management and governance will be challenging, especially so for groups that operate in multiple jurisdictions. Solvency II will require greater disclosure and transparency together with additional and more frequent reporting. For example, it is likely that firms will have to disclose their regulatory capital requirements, including any material solvency breaches, in their annual Solvency and Financial Condition (SFC) report. Firms may need to make material system changes to accommodate these new requirements.

*Firms intending to use an internal model need to be fully engaged with the FSA's pre-application process.*

In order to determine the appropriate level of regulatory capital commensurate with risk profile, firms will need to decide whether to use the standard formula, the standard formula amended with undertaking specific parameters, or an internal model approach, whether partial or full. There is a risk that firms may make inappropriate decisions. Firms wishing to use internal models to calculate some or all of their Solvency Capital Requirement (SCR) will need to ensure that they are fully engaged with the FSA's pre-application process ahead of their application for internal model approval. Pre-application is an essential element of the Solvency II internal models regime. We have signalled that firms intending to apply to use an internal model under Solvency II will be allowed to start pre-application from April 2010.

<sup>2</sup> It will apply to all firms in both the life and general insurance markets where the firm's annual gross written premium income exceeds €5 million and the firm's total of technical provisions exceeds €25 million.

The pre-application qualifying criteria, as originally outlined in DP08/4 are:

- Completion of Quantitative Impact Study 4 (QIS4) and any other subsequent QIS exercise;
- Demonstrating substantial progress towards documentation of their model, including an indication of progress towards satisfying the various requirements to be set;
- Provision of their Solvency II implementation plan; and
- Details of plans to develop their internal model on an iterative basis.

The next 18 months will be critical for those firms intending to follow the internal model route for calculation of their SCR.

The combination of the timeline, the uncertainty over requirements and the breadth of change required by some firms, means that there is a significant risk of not implementing on time, or to an appropriate level of quality.

#### Key messages

- Preparations should be well advanced for the Solvency II regime: it is important that firms are vigilant in keeping up to date with developments and published material on Solvency II. Preparations should include developing internal models (if they wish to utilise one) and participating in QIS5 – which we expect to be the subject of a draft paper at the end of March 2010.
- All firms in scope for Solvency II need to be planning now for all of its implications. Planning must extend well beyond the Pillar 1 calculation kernels and incorporate the very significant changes to governance, enterprise risk management, reporting and public disclosure that are the bedrock of Pillars 2 and 3.

## International developments – International Association of Insurance Supervisors (IAIS)

This section is included to provide context for international developments and to enable firms to monitor developments rather than to take action.

Formed in 1994, the IAIS brings together regulatory and supervisory authorities from approximately 190 jurisdictions in 140 countries, which account for 97% of the world's insurance premiums. The IAIS sets the recognised international standards for insurance, sitting alongside the Basel Committee and International Organisation of Securities Commissioners (IOSCO), and responds to direction from the Financial Stability Board.

The IAIS contributes to the development of well-regulated insurance markets for the benefit and protection of policyholders by setting international standards, promoting their effective implementation, and providing guidance on their application. The standards cover the major regulatory areas, such as licensing, supervisory and prudential matters (including solvency), and governance. These standards are part of the core set used by the International Monetary Fund and World Bank under the Financial Sector Assessment Programme.

*The IAIS is promoting group-wide supervision for insurers and is developing a common supervisory framework.*

The IAIS is currently engaged in international discussions on the issue of financial stability and systemically important financial institutions. To achieve the desired macro-prudential outcomes, the IAIS believes that it is necessary for insurers to be supervised on a group basis, to include non-regulated entities and/or non-operating holding companies within a group. We support this position.

A number of other initiatives are also under way with our active involvement. First, in January 2010 recommendations on a framework to enhance the supervision of international insurance groups and their group-wide risks were approved. This will include the development of approaches to monitor group structures, group business mix and intra-group transactions better, with a view to identifying risks and establishing safeguards where necessary. A comprehensive concept paper is planned for consultation in the first half of 2011 and the full framework will be agreed by 2013. This will be followed by impact assessments. Second, the existing standards and guidance are being reviewed to ensure they reflect lessons learned from the financial crisis, such as the treatment of non-regulated entities, or address particular pressure points, such as the need for improved enterprise-wide risk management, stress testing, asset-liability management and corporate governance. Third, work continues on the development of the Multilateral Memorandum of Understanding on supervisory cooperation and information exchange, and on cross-border cooperation on crisis management.



**PUB REF: 002128c**

The Financial Services Authority  
25 The North Colonnade Canary Wharf London E14 5HS  
Telephone: +44 (0)20 7066 1000 Fax: +44 (0)20 7066 1099  
Website: [www.fsa.gov.uk](http://www.fsa.gov.uk)

Registered as a Limited Company in England and Wales No. 1920623. Registered Office as above.